Inland Revenue
Te Tari Taake

RULINGS > PRODUCT

Fonterra Co-operative Group Limited

26 March 2021

BR Prd 21/02

The Arrangement is the establishment and operation of the Fonterra Shareholders' Fund (FSF). The FSF is a New Zealand–resident unit trust through which non–milk-supplying investors (Public Investors) and farmers supplying milk to Fonterra (Supplying Shareholders) can invest in Units. Units in the FSF give Public Investors and Supplying Shareholders economic rights in Fonterra shares (Shares), but do not give them any legal interest in the Shares.

START DATE – END DATE
{01/01/2021 – 31/01/2026}

(THIS TITLE PAGE DOES NOT FORM PART OF THE RULING.)

Product Ruling – BR Prd 21/02

This is a product ruling made under s 91F of the Tax Administration Act 1994.

Name of person who applied for the Ruling

This Ruling has been applied for by Fonterra Co-operative Group Limited (Fonterra).

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of ss BG 1, CD 4, CD 5, CD 6, CX 56, CX 56B, DA 1, DB 23, subpart HM, and the definition of "foreign investment variable-rate PIE" in s YA 1.

The Arrangement to which this Ruling applies

The Arrangement is the establishment and operation of the Fonterra Shareholders' Fund (FSF). The FSF is a New Zealand–resident unit trust through which non–milk-supplying investors (Public Investors) and farmers supplying milk to Fonterra (Supplying Shareholders) can invest in Units. Units in the FSF give Public Investors and Supplying Shareholders economic rights in Fonterra shares (Shares), but do not give them any legal interest in the Shares.

Units in the FSF are issued when a Supplying Shareholder, registered volume provider (RVP) (whose Shares are held in the name of the Custodian on trust for the RVP), or Fonterra transfers the legal ownership of Shares to Fonterra Farmer Custodian Limited (Custodian). The Custodian holds the economic rights in those Shares on trust for The New Zealand Guardian Trust Company Limited as trustee of the FSF (Supervisor).

The FSF was established in November 2012. Trading in FSF Units commenced on the NZX Main Board on 30 November 2012. A total of 95,454,545 Units were on issue at that date, for a total consideration of $525 million.

Further details of the Arrangement are set out in the paragraphs below.

Parties to the Arrangement

1) The parties to the Arrangement are:

   a) Fonterra,

   b) the FSF (through the Manager or Supervisor),

   c) Donald Hammond, Donna Smit and Ian Brown in their capacity as trustees of the Fonterra Farmer Custodian Trust (Farmer Trustees),

   d) the Custodian,

   e) the Supervisor,

   f) FSF Management Company Limited as manager of the FSF (Manager),

   g) Supplying Shareholders,

   h) RVPs, and

   i) Public Investors.

2) Supplying Shareholders, RVPs, Farmer Trustees, Fonterra and Public Investors may invest in the FSF. Together, they are referred to as the Unit Holders.

3) The Farmer Trustees hold one Unit in the FSF (the Fonterra Unit) which has special, essentially veto, rights (cls 4.5 to 4.8 of the Trust Deed). These special rights mean the Farmer Trustees must approve, for example, an amendment to, removal of or alteration of a provision in the Trust Deed where that amendment, removal or alteration would change the:

   a) governance structure of the board of the Manager,

   b) scope and role of the trust fund,

   c) obligation of the trust to facilitate the exchange of a Share for a Unit or a Unit for a Share, or

   d) 15% limit on the number of Units that any person or their associated persons (other than Fonterra or a wholly-owned subsidiary of Fonterra) can hold, or

   e) terms of the Fonterra Unit.

4) The rights of the Fonterra Unit to proceeds and distributions from the FSF are the same as for all other Units (cl 4.5(h) of the Trust Deed).

Documents relevant to the Arrangement

5) The following documents are relevant to the Arrangement:

   a) Fonterra Shareholders' Fund Trust Deed dated 23 October 2012 and as amended and restated on 17 June 2019 (which established the FSF) (Trust Deed),

   b) Fonterra Shareholders' Fund Authorised Fund Contract dated 25 October 2012 and as amended and restated from 1 November 2016, under which the FSF was established as an "Authorised Fund" under Fonterra's Constitution,

   c) Deed of Trust establishing the Fonterra Farmer Custodian Trust dated 25 October 2012, which holds all shares in the Custodian and the Fonterra Unit,

   d) Custody Trust Deed for the Fonterra Economic Rights Trust dated 25 October 2012, under which the Custodian holds the legal title to Shares and holds the economic rights in Shares on trust for the Supervisor, and

   e) Constitution of Fonterra Co-operative Group Limited (Constitution), which was adopted in November 2020.

Background to the Arrangement

6) Fonterra is simultaneously registered as a co-operative dairy company under Part 3 of the Co-operative Companies Act 1996 and as a company under the Companies Act 1993. The Dairy Industry Restructuring Act 2001 (DIRA) governs many aspects of Fonterra's structure and operation.

7) Supplying Shareholders must generally hold such number of Shares as is determined by the share standard (currently set in Fonterra's Constitution as being one share for each kilogram of milksolids obtainable from milk supplied by the farmer in that season, save that Shares cannot be issued to a farmer whose supply of milksolids is less than 1,000kg in a season). These Shares are informally known as "wet" shares, as they are backed by the supply of milk. In practice, Supplying Shareholders must indicate in advance how much milk they wish to supply in a coming season, and they must acquire or dispose of the appropriate number of Shares to back that supply (within certain margins). Supplying Shareholders may also comply with the share standard through the holding of "vouchers" (discussed further in [30]).

8) In addition to their "wet" Shares, Supplying Shareholders may acquire further Shares (currently up to 100% of the number of shares that they must hold under the share standard). These Shares are informally known as "dry" Shares, as they are not backed

by the supply of milk. Despite the informal distinction between wet Shares and dry Shares, all Shares of Fonterra belong to a single class of share.

9) In the past, s 98 of the DIRA required Fonterra to pay a surrender value for Shares when a Supplying Shareholder gave a notice of withdrawal under s 97 of the DIRA. The ability for farmers to surrender their Shares in this way led to volatility in Fonterra's capital, referred to by Fonterra as redemption risk.

10) To address this redemption risk, Fonterra changed its capital structure in three stages. The changes, referred to as Trading Among Farmers, included:

   a) enabling farmers to acquire up to 100% of the number of Shares they must hold under the share standard as dry Shares,

   b) establishing the FSF to enable public investment, and

   c) creating a "private market" (the Fonterra Shareholders' Market (FSM)) for the trading of Shares between Supplying Shareholders, RVPs (whose Shares are held in the name of the Custodian in trust for the RVP) and Fonterra (together referred to as Permitted Persons). Fonterra is involved in the FSM so it can manage the size of the FSM by conducting buybacks of Shares.

11) The DIRA was also amended to remove the requirement for Fonterra to accept the surrender of Shares on request. This amendment was brought into force in November 2012 by Order-in-Council and removed the redemption risk.

The Arrangement

12) The FSF is a passive investment vehicle through which a Public Investor can invest indirectly in Fonterra. The FSF was established as a unit trust under the Unit Trusts Act 1960 on 23 October 2012 (though is no longer a "unit trust" under the Unit Trusts Act 1960 following the repeal of that Act).

13) The FSF has elected to be a "foreign investment variable-rate PIE" (as defined in s YA 1) and to use the exit calculation option (under s HM 42). The Commissioner confirmed this by letter dated 13 November 2012.

14) The purpose of the FSF is to support the FSM by acting as a conduit for Public Investors to access the underlying economic rights in a Share, thereby creating a more liquid market for Supplying Shareholders (and RVPs) to trade in Shares. This mechanism allows Supplying Shareholders to sell economic rights in Shares to the FSF, as well as selling Shares on the FSM. It also allows an RVP to move between the FSF and FSM to match supply and demand and possibly hedge its position. While

Supplying Shareholders may invest in the FSF, most of the Unit Holders are not Supplying Shareholders.

Registered volume providers

15) Fonterra has appointed one RVP, Craigs Investment Partners (although it retains the discretion to appoint further RVPs), to acquire and dispose of Shares (through the Custodian) on the FSM to facilitate trades and liquidity in that market. The principal duties of RVPs are to ensure the smooth execution of transactions and improve liquidity through continuous quoting of buy and sell orders with a contracted maximum spread between the buy and sell prices quoted. A main role of RVPs is to ensure the spread between buy and sell prices is restricted to a narrow range.

16) Under the Constitution, RVPs must hold, in aggregate, rights or interests in no more than 5% of the total Shares on issue at any time, excluding treasury stock (such Shares being held in the name of the Custodian in trust for the RVP). Fonterra and the RVPs have not and will not enter into a risk-sharing agreement. However, where the RVP is suspended from selling economic rights in relation to Fonterra Shares to the FSF, Fonterra will compensate the RVP for certain trading losses suffered by the RVP.

17) As with Supplying Shareholders, RVPs can also participate in the FSF. This promotes price convergence between the FSM and the FSF.

Supervisor, Manager and Custodian

18) Fonterra appointed the initial Supervisor as trustee of the FSF. The Supervisor is licensed under the Financial Markets Supervisors Act 2011.

19) Fonterra also appointed the initial Manager of the FSF. The initial Manager is a company wholly owned by Trustees Executors Limited. Under the Financial Markets Conduct Act 2013, the role of the Manager is to manage the investments of the FSF and issue Units to the public. The Manager manages the FSF as an investment vehicle and does not undertake an active role (such as actively soliciting farmers to sell economic rights in their Shares). Fonterra provided a licence (the Licence) to the Manager to use Fonterra's name and brand for the purposes of the FSF.

20) The Supervisor and Manager are party to an arrangement (the Funding Arrangement) with Fonterra under which Fonterra provides the FSF with funds at the start of each financial year to cover the reasonable expenses incurred by the FSF, or the Manager, on behalf of the FSF (Operating Expenses) in accordance with a budget agreed between the parties.

21) The Custodian is a limited liability company set up to hold legal title to the Shares. The Custodian holds legal title to any Shares in which economic rights have been sold to the FSF and holds the economic rights in Shares on trust for the Supervisor (under the Fonterra Economic Rights Trust). The Custodian also holds legal title to any Shares acquired by the RVP on trust for the RVP (under a separate trust from the Fonterra Economic Rights Trust).

22) The Custodian is wholly owned by the Farmer Trustees, as trustees of the Fonterra Farmer Custodian Trust. The Fonterra Farmer Custodian Trust is a trust set up for the sole purpose of holding the shares in the Custodian and the Fonterra Unit. The Farmer Trustees are three farmer representatives (a farmer directly elected by Supplying Shareholders, a director of Fonterra elected by Supplying Shareholders, and a member of the Fonterra Shareholders' Council). The discretionary beneficiaries of the trust are Supplying Shareholders, and Fonterra is the final beneficiary of the trust.

23) The Custodian (and the FSF) does not have voting rights in Fonterra under the Constitution, which restricts voting rights to Supplying Shareholders (that is, production-based voting rights), except at a meeting of an interest group where there would otherwise be no shareholder entitled to vote at that meeting under cl 24.2(c) of the Constitution. Under cl 7.8 of the Constitution, the Authorised Fund Contract is required to prohibit the FSF and the Custodian from exercising, controlling or exerting any influence over any voting rights attached to the Shares. The Trust Deed and Custody Trust Deed also contain provisions preventing the FSF and the Custodian from exercising any influence over voting rights attached to the Shares.

24) Under cl 7.1 of the Custody Trust Deed, the income of the Fonterra Economic Rights Trust includes amounts of deemed income that arise under tax law, and the Custodian is permitted to distribute this income to the FSF.

Operation of the Fonterra Shareholders' Fund

25) Supplying Shareholders, RVPs and Fonterra can transfer economic rights in Shares to the FSF. In this context, "economic rights in Shares" means the rights to receive dividends and other benefits derived from a Share, including any change in value of the Share, as well as the other rights and benefits attached to the Share. It does not include any right to hold the legal title to a Share or a security convertible to a Share or to exercise production-based voting rights.

26) The process for selling economic rights in Shares to the FSF involves two steps:

    a) Supplying Shareholders, RVPs and Fonterra transfer legal title to a Share to the Custodian (legal title to the Share does not pass to the FSF).

b) The Custodian holds the economic rights in the Shares on trust for the Supervisor.

27) The economic rights in Shares are the FSF's only material asset. Under cl 7.5 of the Constitution, the aggregate number of Shares in which the FSF may acquire economic rights is limited to 20% of the total number of Shares on issue (excluding treasury stock). If this limit is exceeded, the board of Fonterra must, within an appropriate timeframe, take steps to bring the number of Shares in respect of which the economic rights are held for the FSF back within the limit (cl 7.6 of the Constitution).

28) The Manager issues Units in the FSF when the Custodian receives a Share, which gives rise to the receipt of economic rights in a Share by the FSF. In addition, if Fonterra issues further Shares in respect of a Share the Custodian holds (in respect of which economic rights are being held in favour of the Supervisor), the FSF will issue a corresponding number of Units to its Unit Holders under cl 15.1(d) and (e) of the Trust Deed. This ensures the number of Shares placed with the Custodian in which economic rights are being held in favour of the Supervisor always equals the number of Units on issue. Clause 15.1(a) and (b) of the Trust Deed provides for the payment of cash dividends or other cash benefits to Unit Holders, mirroring payments on the Shares, as follows:

a) upon receipt of a Cash dividend or other Cash Benefits (other than a Supplementary Dividend) paid by Fonterra, this will be distributed to Unit Holders who were recorded in the Register at the same time and on the same record date as applied by Fonterra to determine the entitlement to the cash dividend or other cash Benefits. The amount to be paid or transferred to each such Unit Holder in respect of each Unit held by that Unit Holder as at that time, will be equal to the amount Fonterra paid or transferred per Share adjusted to take into account any Tax Liability of the Trust relating to the Unit Holder or any adjustments in accordance with section HM 48 of the Tax Act, and less any non-resident withholding tax deducted in respect of the Unit Holder in accordance with subpart RF of the Tax Act pursuant to section HM 44B of the Tax Act and less any sum authorised in accordance with an Extraordinary Resolution pursuant to paragraph 11.1(b)(viii) of Schedule 1;

b) upon receipt of any Supplementary Dividend paid by Fonterra, this will be distributed to the Unit Holders that entitled Fonterra to apply section LP 2 of the Tax Act and receive a tax credit for the Supplementary Dividend;

29) Each Supplying Shareholder or RVP who transfers Shares to the Custodian (in which economic rights have been sold to the FSF) receives either one Unit in the FSF for each such economic right in a Share transferred or a cash sum (cl 5.1 of the Trust Deed) in recognition of the transfer of the economic right in the Share to the FSF. Supplying Shareholders cannot retain Units that they receive in consideration for the transfer of

Shares to the Custodian (in which economic rights have been sold to the FSF). These Units must be sold on the NZX Main Board or ASX to settle a sale contract previously entered into in the relevant market.

30) Supplying Shareholders who sold economic rights in wet Shares to the FSF as part of the establishment of Trading Among Farmers (and as part of a subsequent one-off offer by Fonterra to purchase Units in October 2012) also received "vouchers" that count towards the share standard and support production-based voting rights and the right to full share backed milk price (cl 5.3 of the Trust Deed). Fonterra's Constitution gives the Fonterra Board the discretion to maintain a policy that would permit Supplying Shareholders to sell the economic rights in wet Shares to the FSF on a day-to-day basis and (subject to individual limits) to receive "vouchers" in partial consideration for the sale of those economic rights. While the Board keeps this policy under review, Supplying Shareholders are not currently entitled to sell economic rights in wet Shares to the FSF or to receive vouchers in connection with such sale.

31) Under the Trust Deed, each Unit the FSF issues evidences the holder's entitlement to the economic benefits (including distributions and other benefits) in the whole of the trust fund. As the number of Units the FSF issues equals the number of Shares the Custodian holds (in which economic rights are being held in favour of the Supervisor), in effect, each Unit provides rights to receive the distributions and other benefits in respect of one Share. Individuals and their associates must not hold more than 15% of the lesser of the total number of Units on issue or the total voting rights in the FSF (cl 6.1 of the Trust Deed).

32) The Units in the FSF (including the Fonterra Unit) carry in respect of the FSF a right to vote or participate in any decision-making concerning at least one of the following:

a) a dividend or other distribution to be paid or made by the FSF, or

b) any variation to the Trust Deed.

33) Clause 4.1(c) of the Trust Deed sets out that the Units do not confer any interest in certain amounts under the Trust Deed, as follows:

> c) Unless the Manager directs otherwise, Units shall not confer any interest in interest income of the Trust. Units shall not confer any interest in monies paid to the Supervisor or the Manager to meet their fees or to reimburse either of those parties for (or any advance payment in respect of) any expenses, liabilities, losses and costs incurred by them respectively in or about acting as Supervisor or Manager (as the case may be) under this Deed. In all cases, all interest income and such monies will be applied by the Manager to meet the fees and expenses, liabilities, losses and costs incurred by the Manager or the Supervisor in or about acting as Manager or Supervisor (as the case may be).

34) The FSF Units trade on a registered market (the NZX Main Board and ASX) in which Supplying Shareholders, RVPs, Fonterra and other Public Investors may participate. Standard listing rules (but with various exemptions to those rules recognising that it is a unit trust and to accommodate other characteristics of Trading Among Farmers) apply to the FSF. Fonterra and the FSF co-operate with each other in relation to matters such as disclosure of information to enable the FSF to comply with the listing rules applicable to the FSF.

35) Supplying Shareholders, RVPs and Fonterra can exchange Units for Shares subject to various limits, but no other investor can (cl 9 of the Trust Deed). For example, if a Supplying Shareholder, Fonterra or an RVP wished to acquire a Share, it could do so either by buying a Share on the FSM or by buying a Unit and presenting that Unit to the Supervisor for redemption and demanding that the Supervisor procure the Custodian to transfer to it (or in the case of the RVP, to the Custodian to hold on trust for the RVP) one Share.

36) Under cls 6.5 and 7.8 of the Constitution and cl 15.2 of the Trust Deed, neither the RVPs nor the FSF (or the Custodian in relation to either) is entitled to exercise any voting rights attached to Shares that the Custodian, from time to time, holds for them (except on an interest group resolution where otherwise no shareholder can vote: cl 24.2(c) of the Constitution).

37) Except as noted in [35], no Unit Holder may require the transfer to themselves of any of the property of the FSF or any Share. The Supervisor covenants that it will not call for a transfer of the Shares (cl 4.8 of the Custody Trust Deed). In addition, no Unit Holder may redeem their Units for cash other than as described in cl 15.1(h) of the Trust Deed. However, Unit Holders may sell their Units to other investors on the NZX Main Board or ASX.

38) In addition to dividends, which are expected to be paid twice a year, other potential distributions in respect of the Shares include:

a) taxable and non-taxable bonus issues,

b) in-specie distributions of property,

c) share buy-backs,

d) dividend reinvestment schemes,

e) renounceable and non-renounceable rights issues, and

f) notional distributions.

39) Section 16 of the Dairy Industry Restructuring Amendment Act 2012 inserted ss 161A and 161B into the DIRA to allow Fonterra to hold Units in the FSF. Fonterra maintains a unit-holding in the FSF that may increase or decrease but will always hold at least one Unit. In respect of Units Fonterra holds, the DIRA prevents Fonterra from exercising any voting rights carried by those Units (s 161A(i)).

40) The FSF may derive income other than from the Shares the Custodian holds on its behalf such as interest on cash held in a bank account and amounts received under the Funding Arrangement (Other Income). To the extent the Fund derives Other Income, cl 4.1(c) of the Trust Deed provides that no Unit Holder has an interest in such Other Income, unless the Manager directs otherwise. Any Other Income that is available to the FSF is paid to the Supervisor as part of the fees due to the Supervisor.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The requirements of ss HM 55D(5), (6) and (7), HM 55E, HM 55F and HM 55FB are met in relation to notified foreign investors in the FSF.

(b) The FSF is not treated under any double tax agreement as not being resident in New Zealand.

(c) The FSF is not in the business of life insurance.

(d) 90% or more of the FSF's investments (by value of its assets) are investments of a type referred to in s HM 11, other than an interest in land in New Zealand or a right or option in relation to land in New Zealand, in accordance with s HM 19C(1).

(e) 90% or more of the income derived by the FSF is of a type referred to in s HM 12, other than an amount derived from an interest in land in New Zealand or the disposal of an interest in land in New Zealand, in accordance with s HM 19C(2). For the avoidance of doubt, this condition will not be breached if any failure to meet the requirement of s HM 12 is not "significant and within control of the FSF" and is remedied by the last day of the next quarter, in accordance with s HM 25.

(f) The FSF has not lost its PIE status through the application of s HM 25, s HM 27 and/or s HM 29.

(g) The FSF has not changed its election to use the exit calculation option in s HM 42.

How the Taxation Laws apply to the Arrangement

Subject in all respects to any conditions stated above, the Taxation Laws apply to the Arrangement as follows:

(a) The FSF qualifies as a "foreign investment variable-rate PIE" (as defined in s YA 1).

(b) The FSF's interest in the Shares is an investment of a type referred to in s HM 11.

(c) Income derived by the FSF from its interest in the Shares is income of a type referred to in s HM 12.

(d) Income attributed by the FSF to its investors is "excluded income" (as defined in s BD 1(3)) of the investor under s CX 56(3) provided that:

   (i) the prescribed investor rate for the investor is more than zero and not more than the investor's notified investor rate when the PIE calculates its income tax liability under s HM 47, or makes a voluntary payment under s HM 45, or

   (ii) the investor is one of those listed in s CX 56(1B), or

   (iii) the investor is one of those listed in s CX 56(1C) and has made the necessary election under s HC 33, and

   (iv) the amount is not an amount of attributed PIE income that is derived by a trustee who has chosen a prescribed investor rate referred to in sch 6, table 1, row 5 or 7, as applicable, and

   (v) the investor is not a new New Zealand resident to whom s HM 57B would have applied but who has chosen not to apply that section to determine their prescribed investor rate for a "resident year" (as defined in s HM 57B(3)), and

   (vi) the amount is not an amount of PIE schedular income derived by a natural person who is an investor in the PIE.

(e) Where a Permitted Person acquires a Share on redemption of a Unit, and is entitled to a deduction under ss DA 1 and/or DB 23, the cost or amount of expenditure incurred in acquiring the Share for the purposes of those sections will be the market value of the redeemed Unit on the day it was redeemed.

(f) The redemption of a Unit in the FSF by a Unit Holder, in exchange for a Share, will not give rise to a dividend under ss CD 4 to CD 6.

(g) Any distributions from the FSF are excluded income of each Unit Holder under s CX 56B (and therefore not taxable), other than where the FSF elects to pay non-resident withholding tax in accordance with s HM 44B in respect of the distribution.

(h) An investor in the FSF who is a natural person will have no adjustment to their terminal tax liability under s HM 36B in respect of income attributed by the FSF to the investor if that investor has notified the correct prescribed investor rate and the FSF has satisfied the investor's tax liability by applying that notified rate.

(i) The Arrangement is not subject to s BG 1.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 January 2021 and ending on 31 January 2026.

This Ruling is signed by me on the 26th day of March 2021

Fiona Wellgreen
Senior Tax Counsel

About this document

Product Rulings are issued by the Tax Counsel Office and Customer and Compliance Services. Product Rulings set out the Commissioner's view on how tax laws apply to a particular "product" – which is an arrangement that a specified taxpayer is likely to enter into with a number of people on identical terms. Taxpayers who enter into the arrangement described in a Product Ruling may apply the ruling, but are not obliged to do so. Product Rulings are binding on the Commissioner. This means that if you are entitled to apply a Product Ruling and you have calculated your tax liability in accordance with the ruling, the Commissioner must accept that assessment. A Product Ruling applies only to the taxation laws and arrangement set out in the ruling, and only for the period specified in the ruling. It is important to note that a general similarity to an arrangement covered by a Product Ruling will not necessarily lead to the same tax result.